

OFFICE OF THE AUDITOR GENERAL

228.1

REVIEW OF
INSURANCE PROCUREMENT PROCEDURES
INSURANCE OFFICE OF THE
DEPARTMENT OF GENERAL SERVICES

DECEMBER 1974

Joint Legislative Audit Committee

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California Legislature

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December 17, 1974

The Honorable Speaker of the Assembly
The Honorable President of the Senate
The Honorable Members of the Senate and the
Assembly of the Legislature of California

Members:

Transmitted herewith is the Auditor General's report pertaining to the procedures utilized by the Insurance Office of the Department of General Services for the procurement of insurance for state agencies. In fiscal year 1973-74, major insurance contracts included \$2,290,000 for vehicle liability insurance.

Based on a June 1974 analysis of bids for vehicle insurance for the state's 28,000 automobiles, trucks and trailers, the Insurance Office estimated that the cost of a self-insurance program would be \$514,800 less than the cost of a full insurance program over the three-year period ending June 30, 1977.

However, despite such estimated savings from a self-insurance program, the Insurance Office adopted a full insurance program providing coverage of up to \$2,000,000 per accident. The self-insurance program, not selected, would have provided insurance coverage through premiums paid by the state to insurance companies for losses from \$50,000 to \$2,000,000 with the state itself paying the losses below \$50,000 per accident.

As a result of not adopting this self-insurance program, the Auditor General has estimated that excessive costs ranging from \$500,000 to \$1,000,000 will be incurred over the three-year period ending June 30, 1977.

The Auditor General has recommended that the Insurance Office of the Department of General Services cancel the current insurance policy providing full insurance up to \$2,000,000

The Honorable Members of the Legislature
of California
December 17, 1974
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for the state's 28,000 vehicles and begin a self-insurance program for losses below \$50,000 per accident. He has further recommended that full insurance be procured for losses from \$50,000 to \$2,000,000.

The Insurance Office of the Department of General Services charges vehicle insurance costs to state agencies on the basis of a flat rate per vehicle without regard to actual loss experience. As a result, the vehicle insurance costs of certain specially funded programs have been subsidized by General Fund tax revenues in the amount of \$414,300 for the three-year period ended June 30, 1974. Further, as a result, state agencies with low loss experience subsidize other state agencies with high loss experience.

The Auditor General has recommended that the Insurance Office charge vehicle insurance costs to the state agencies on the basis of the agencies' actual loss experience in lieu of a charge based on a flat rate per vehicle.

Under the workmen's compensation contract administered by the Insurance Office of the Department of General Services, reimbursements paid by state agencies from 1969 through 1973 to the State Compensation Insurance Fund, for workmen's compensation claims adjustment and administrative services rendered by the Fund, have exceeded the Fund's costs by \$673,000.

Since the reimbursements to this Fund are calculated as a percentage of the disability benefits paid to state employees, and since there has been a more rapid increase in benefit payments than in the claims adjustment and administrative services costs of the Fund, state agencies are reimbursing the Fund more than the actual cost of the services rendered by the Fund.

It is recommended that the Insurance Office renegotiate the workmen's compensation contract with the State Compensation Insurance Fund in order that the reimbursements paid by state agencies to the Fund do not exceed the cost of the services rendered by the Fund. It is further recommended that the Insurance Office request a refund of \$673,000 from the Fund.

Respectfully submitted,



VINCENT THOMAS, Chairman
Joint Legislative Audit Committee

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INTRODUCTION

In response to a legislative request, we have reviewed the procedures utilized by the Insurance Office of the Department of General Services for the procurement of insurance for state agencies.

The Insurance Office provides centralized management of the state's insurance needs, representing the state in the purchasing of insurance coverage including:

- Selecting insurance brokers to seek insurance proposals from insurance companies for coverage on behalf of the state
- Preparing specifications for insurance coverage
- Analyzing proposals for insurance coverage
- Reviewing the insurance policies for form and rate.

The Department of General Services is required by Section 11007.7 of the Government Code to approve the procurement of insurance for all state agencies except for the State Compensation Insurance Fund and the University of California, and certain insurance coverage for the Department of Veterans Affairs and the California Toll Bridge Authority. The audit scope in this report excludes the procurement of insurance by these four agencies.

The state paid \$3,475,000 in fiscal year 1973-74 for insurance protection against liability and property losses, excluding the four agencies shown on the previous page. Major insurance contracts included \$2,290,000 for vehicle liability insurance, \$355,000 for the Oroville-Thermalito Project, and \$200,000 for the state's excess tort liability coverage.

With regard to vehicle insurance, the state contracts with insurance companies to insure for its liabilities relating (1) to injuries to persons other than state employees, and (2) to damages to non-state property. Injuries to state employees and damages to state vehicles are self-insured.

FINDINGS

THE INSURANCE OFFICE OF THE DEPARTMENT OF
GENERAL SERVICES ADOPTED A FULL INSURANCE
PROGRAM FOR THE STATE'S 28,000 VEHICLES
IN LIEU OF A SELF-INSURANCE PROGRAM FOR
LOSSES BELOW \$50,000 PER ACCIDENT. AS A
RESULT, EXCESSIVE INSURANCE COSTS ESTIMATED
AT \$514,800 WILL BE INCURRED OVER THE
THREE-YEAR PERIOD ENDING JUNE 30, 1977.

Based on a June 1974 analysis of bids for vehicle insurance, including automobiles, trucks and trailers, the Insurance Office of the Department of General Services estimated that, if purchased from an insurance company, the cost of fully insured liability coverage for the state's 28,000 vehicles would be \$7,711,600 for the three-year period ending June 30, 1977. The Insurance Office estimated that, for the same period, the cost of a program of self-insurance would be \$7,196,800, or \$514,800 less than the cost of the fully insured program.

However, despite the savings from the self-insurance program estimated by the Insurance Office, the office adopted a full insurance program. Under this latter program, the vehicle insurance policies purchased by the Department of General Services provide liability coverage from zero to \$2,000,000 per accident. The insurance companies have the right to adjust the premium rate annually and to cancel the policies after 90 days' written notice.

The self-insurance proposal, not selected, would have provided insurance coverage from insurance companies for losses from \$50,000 to \$2,000,000 with the state paying the losses below \$50,000 per accident. Losses

below \$50,000 per accident for the eleven-year period ended June 30, 1973 were \$10,941,000 or 79 percent of the total losses of \$13,799,000.

For the three-year period ended June 30, 1977, the estimated costs of the program of full insurance versus the self-insurance program, as determined by the Insurance Office of the Department of General Services, are shown in the table below:

Table 1

| | <u>Self- Insurance Program Costs</u> | <u>Full Insurance Program Costs</u> | <u>Excess of Premium Costs For Full Insurance Over Self Insurance</u> |
|---|--|---|---|
| Premiums paid to insurance companies for losses from zero to \$2,000,000 | \$ -- | \$7,106,100 | \$7,106,100 |
| Premiums paid to insurance companies for losses from \$50,000 to \$2,000,000 | 1,485,000 | -- | (1,485,000) |
| Loss payments to injured parties below \$50,000 per accident (self-insurance) | 4,987,500 | -- | (4,987,500) |
| State administrative costs | 578,800 | -- | (578,800) |
| Lost interest to the state at 6 percent* | <u>145,500</u> | <u>605,500</u> | <u>460,000</u> |
| Total estimated costs | <u>\$7,196,800</u> | <u>\$7,711,600</u> | <u>\$ 514,800</u> |

*Interest is lost because premium payments are paid to insurance companies during the policy period whereas the accident claims are paid over a period of time which extends beyond the policy period. Thus, the state loses the interest which could be earned if the state had control of the funds until the claims are paid.

The current interest rates are substantially higher than the six percent used in the estimate by the Department of General Services. Using an average interest rate of nine percent, which was the approximate rate earned in fiscal year 1973-74 by the State's Pooled Money Investment Board, the self-insurance program would cost \$1,002,900 less than the full insurance program for the three-year period ended June 30, 1977.

Under a self-insurance program, the state could establish a fund for vehicle insurance for losses below \$50,000 per accident. Premiums would be paid to the self-insurance fund rather than to the insurance companies, and the losses, administration costs and insurance premiums for losses from \$50,000 to \$2,000,000 would be paid out of the fund.

The largest cost under the self-insurance program is loss payments to injured parties below \$50,000 per accident. Such costs were estimated at \$4,987,500, or approximately 71 percent of the total cost, excluding lost interest. The loss per vehicle was developed by the Department of General Services based on the prior experience of the state, which for the last several years has been relatively constant.

Department of General Services officials stated that the reason for not immediately selecting a self-insurance program, despite their analysis that such a program would be less expensive than a program of full insurance, was because estimated savings under the self-insurance program were not large enough. They stated that actual losses to injured parties below \$50,000 per accident might be greater than such estimated losses used in their analysis of the self-insurance proposal, and therefore the estimated savings did not justify the potential risks without a further detailed analysis.

Assuming loss payments to injured parties under a self-insurance program are more than estimated, these excess costs must be paid by a self-insurance fund. However, under the current full insurance program, the insurance companies have the right to adjust the rates annually to offset any increased costs and to cancel the coverage on 90 days' written notice. For example, the state's prior vehicle insurance contractor in 1973 increased its rates as a result of unfavorable loss experience by an additional \$100,000; and in 1972, a vehicle insurance company canceled its excess coverage, costing the state an additional \$126,300 to replace the coverage.

Based on their own analysis of the estimated savings that would accrue to the state under the self-insurance program, an analysis which as previously noted used a conservative interest rate of six percent, we conclude that the Insurance Office should have selected the self-insurance program rather than the full insurance program.

RECOMMENDATION

We recommend that the Insurance Office of the Department of General Services cancel the current insurance policy providing full liability insurance for losses from zero to \$2,000,000 for the state's 28,000 vehicles, and begin a self-insurance program for losses below \$50,000 per accident.

We recommend that full liability insurance be procured by the Insurance Office for losses from \$50,000 to \$2,000,000.

SAVINGS

Implementation of this recommendation will reduce the cost of the state's vehicle insurance by an estimated \$500,000 to \$1,000,000 for the three-year period ended June 30, 1977.

THE INSURANCE OFFICE OF THE DEPARTMENT
OF GENERAL SERVICES CHARGES VEHICLE
INSURANCE COSTS TO STATE AGENCIES ON
THE BASIS OF A FLAT RATE PER VEHICLE
WITHOUT REGARD TO ACTUAL LOSS EXPERIENCE.
AS A RESULT, THE VEHICLE INSURANCE COSTS
OF CERTAIN SPECIALLY FUNDED PROGRAMS HAVE
BEEN SUBSIDIZED BY GENERAL FUND TAX RE-
VENUES IN THE AMOUNT OF \$414,300 FOR THE
THREE-YEAR PERIOD ENDED JUNE 30, 1974.

The Insurance Office of the Department of General Services charges vehicle insurance costs to individual state agencies on a flat rate per vehicle without regard to actual loss experience of the agencies. This has resulted in agencies with low loss experience subsidizing other agencies with high loss experience. Due to the different funding sources of the agencies involved, the vehicle insurance costs of certain specially funded programs have been subsidized by the General Fund.

For example, if loss experience had been used as a basis for charging vehicle insurance in lieu of a flat rate per vehicle, the California Highway Patrol, which is primarily financed by motor vehicle fees and which has 9.57 percent of the state's vehicles and 25.11 percent of the losses, would have paid an additional \$976,200 for vehicle insurance during the three-year period ended June 30, 1974. Conversely, the Department of Parks and Recreation, which is primarily financed by the General Fund and which has 3.66 percent of the state's vehicles and 0.74 percent of losses, would have been charged \$183,400 less for vehicle insurance for the same period if loss experience had been used.

The appendix on page 17 of this report shows by department, for the three years ended June 30, 1974, the percentage of vehicles and the percentage of losses and the overcharge or undercharge which has resulted from using a flat rate rather than actual loss experience for charging vehicle insurance.

The following table shows the portion of the agency overcharges attributable to the General Fund and to special funds, and the net overcharge to the General Fund and undercharge to special funds of \$414,300:

Table 2

Overcharge or Undercharge from Using
A Flat Rate per Vehicle for Charging Costs Of
Vehicle Insurance to State Agencies
In Lieu of Using Loss Experience
For the Three-Year Period Ended June 30, 1974

| <u>State Agencies</u> | <u>Total</u> | <u>Overcharge (Undercharge) To:</u> | |
|------------------------------------|-----------------|-------------------------------------|---------------------|
| | | <u>General Fund</u> | <u>Special Fund</u> |
| Conservation | \$ 89,800 | \$ 64,100 | \$ 25,700 |
| Fish and Game | 96,700 | -0- | 96,700 |
| Food and Agriculture | 172,800 | 92,000 | 80,800 |
| Highway Patrol | (976,200) | -0- | (976,200) |
| Employment Development | (134,400) | (1,400) | (133,000) |
| Motor Vehicles | (6,900) | (5,500) | (1,400) |
| Parks and Recreation | 183,400 | 166,600 | 16,800 |
| State Colleges | 98,000 | 68,400 | 29,600 |
| Transportation | 334,200 | 7,900 | 326,300 |
| Water Resources | 219,900 | 22,200 | 197,700 |
| Other Departments | <u>(77,300)</u> | <u>-0-</u> | <u>(77,300)</u> |
| Net Overcharge to the General Fund | | <u>\$414,300</u> | |
| Net Undercharge to Special Funds | | | <u>\$ (414,300)</u> |

As shown by the table on the previous page, the present method of charging for vehicle insurance on a flat rate per vehicle in lieu of using actual loss experience results in certain agencies with special funding sources being subsidized from General Fund tax revenues.

We conclude that the method used by the Insurance Office of the Department of General Services to charge vehicle insurance costs to individual state agencies is not equitable.

RECOMMENDATION

We recommend that the Insurance Office of the Department of General Services charge vehicle insurance costs to state agencies on the basis of the agencies' actual loss experience in lieu of a charge based on a flat rate per vehicle.

BENEFITS

Implementation of this recommendation will provide for a more equitable basis for vehicle insurance charges and will preclude certain agencies which have special funding sources from being subsidized by General Fund tax revenues.

UNDER THE WORKMEN'S COMPENSATION CONTRACT
ADMINISTERED BY THE INSURANCE OFFICE OF THE
DEPARTMENT OF GENERAL SERVICES, REIMBURSEMENTS
PAID BY STATE AGENCIES FROM 1969 THROUGH
1973, TO THE STATE COMPENSATION INSURANCE
FUND (SCIF) FOR SCIF'S WORKMEN'S COMPEN-
SATION CLAIMS ADJUSTMENT AND ADMINIS-
TRATIVE SERVICES RENDERED, HAVE EXCEEDED
SCIF'S COSTS BY \$673,000.

Most state agencies are self-insured for workmen's compensation claims. SCIF, which provides workmen's compensation insurance to private employers, also provides workmen's compensation claims adjustment and administrative services for state agencies under a contract entered into with the state in 1943 and now administered by the Insurance Office of the Department of General Services. Under this contract, SCIF determines eligibility for benefits and disburses funds to the claimants. However, the benefits are financed by the self-insured state agencies.

The contract provides that the state agencies will reimburse SCIF for claims adjustment and administrative services on the basis of 12-1/2 percent of the disability and medical benefits paid to state employees, except for certain claims by California Highway Patrol employees for which SCIF will be paid 35 percent of the medical benefits, and that these percentages "represent by average the actual cost of services rendered". From 1969 through 1973, such reimbursements have exceeded SCIF's applicable costs by \$673,000.

Since the reimbursements to SCIF are calculated as a percentage of the disability and medical benefits paid to state employees and since there

has been a more rapid increase in benefit payments than in SCIF's claims adjustment and administrative services costs, state agencies are reimbursing SCIF more than the actual costs of the services rendered by SCIF.

From 1969 to 1973, disability and medical benefits financed by self-insured state agencies and paid by SCIF to state employees have increased by \$4.9 million, i.e. from \$7.0 to \$11.9 million, or 69.5 percent, whereas the claims adjustment and administrative services costs applicable to the payments made for all claims, including claims of state employees, processed by SCIF have increased by \$4.2 million, i.e. from \$10.4 to \$14.6 million, or only 40.5 percent.

The following table shows the excess of reimbursement over cost paid to SCIF by state agencies for the five-year period 1969 through 1973.

Table 3

| <u>Year</u> | <u>SCIF Claims Adjustment And Administrative Services Costs Applicable To State Contract</u> | <u>Reimbursements Paid To SCIF By State Agencies</u> | <u>Excess Of Reimbursements Over Costs</u> |
|-------------|--|--|--|
| 1973 | \$1,488,000 | \$1,586,000 | \$ 98,000 |
| 1972 | 1,189,000 | 1,348,000 | 159,000 |
| 1971 | 909,000 | 1,149,000 | 240,000 |
| 1970 | 911,000 | 1,047,000 | 136,000 |
| 1969 | <u>902,000</u> | <u>942,000</u> | <u>40,000</u> |
| Totals | <u>\$5,399,000*</u> | <u>\$6,072,000*</u> | <u>\$673,000</u> |

* Costs and reimbursements were taken from an SCIF study.

SCIF has proposed that the method for reimbursement for claims adjustment services be changed effective January 1, 1975 to reflect changes in benefits provided to state employees through the Industrial Disability Leave (IDL) program. The IDL program is an optional benefit available to injured state employees in which a portion of the employee's salary will continue to be paid for up to 12 months by the state agency in lieu of compensation benefits being paid by SCIF. SCIF will continue to provide claims adjustment services to the state in determining eligibility for the IDL program.

Since the disability benefits will be paid directly by state agencies, SCIF will not have a basis to calculate their service charge; therefore, SCIF has proposed to charge the state 35 percent of medical benefits as a method for recovering their claims adjustment and administrative services costs. Applying the 35 percent rate to the medical benefits paid during the five-year period 1969 through 1973 would have resulted in the SCIF receiving a net excess of reimbursement over cost of \$596,000 as shown in the table below:

Table 4

| <u>Year</u> | <u>SCIF Claims Adjustment And Administrative Services Costs</u> | <u>Proposed Reimbursements At 35 Percent Of Medical Benefits To Be Paid To SCIF By State Agencies</u> | <u>Excess Of Reimbursements Over Costs</u> |
|-------------|---|---|--|
| 1973 | \$1,488,000 | \$1,579,000 | \$ 91,000 |
| 1972 | 1,189,000 | 1,331,000 | 142,000 |
| 1971 | 909,000 | 1,105,000 | 196,000 |
| 1970 | 911,000 | 1,057,000 | 146,000 |
| 1969 | <u>902,000</u> | <u>923,000</u> | <u>21,000</u> |
| Totals | <u>\$5,399,000</u> | <u>\$5,995,000</u> | <u>\$596,000</u> |

Therefore, this proposed change in the method to reimburse SCIF for the claims adjustment and administrative services costs, if adopted, will also result in state reimbursements to SCIF in excess of SCIF's cost.

We conclude that reimbursements by state agencies to SCIF, which provide SCIF with amounts in excess of the costs of their services rendered, are not in the best interests of the state.

RECOMMENDATIONS

We recommend that the Insurance Office of the Department of General Services renegotiate the workmen's compensation contract with the State Compensation Insurance Fund in order that the reimbursements paid by state agencies to SCIF are not in excess of SCIF's costs of rendering claims adjustment and administrative services.

We further recommend that the Insurance Office of the Department of General Services request a refund of \$673,000 from SCIF in order that the amounts paid to SCIF by state agencies from 1969 through 1973 will not have exceeded SCIF's applicable costs.

SAVINGS AND BENEFITS

Implementation of these recommendations will result in a refund to the state of \$673,000 and will result in proper reimbursements to SCIF in future years.

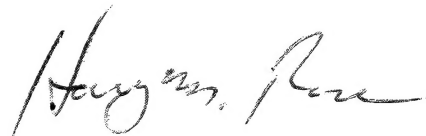
SUMMARY OF AGENCY COMMENTS

Director of the Department of General Services

1. The uncertainties of the risk of self-insurance for the state's vehicles are such that, before taking such action, we will restudy and reevaluate the computation to assure that all loss factors have been considered. If the savings indicated are verified, we will initiate action to become self-insured as recommended. Also, anticipated no-fault insurance may make self-insurance even more desirable.
2. We agree with and will implement the recommendation to charge state agencies for vehicle insurance costs on the basis of actual loss experience. Only recently have there been sufficiently valid statistical data to permit us to make charges to agencies on the basis of actual loss experience.
3. We will require SCIF to fully justify the reasonableness of its charges before entering into future contracts for claims adjustment and administrative services. We also will study the possibility of having Department of General Services employees perform the claims adjustment and administrative services in lieu of contracting with SCIF.

State Compensation Insurance Fund Officials

1. Because of recent changes in the disability benefit program for state employees, future costs of handling the state contract may be higher than past costs; however, the probable amount of any such increased costs is not known at the present time.
2. Cost data developed by SCIF in its study might be understated.
3. A consulting actuary advised SCIF that a study prepared by SCIF in connection with the proposed revision in the reimbursement method for the state contract "seems to confirm that a thirty-five percent factor would have yielded an equitable charge over the past five years".
4. Before any refund is made to the state, a comparison of costs and reimbursements should be made for a period longer than the five years used by the Auditor General since it is possible that in certain earlier years costs may have exceeded the state reimbursements paid to SCIF.



Harvey M. Rose
Auditor General

Date: December 4, 1974

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The Percentage of Vehicles and the Percentage
Of Losses by State Agencies and the
Resulting Overcharges Since Insurance
Costs Are Charged on the Basis of a Flat
Rate per Vehicle Without Regard
To Actual Loss Experience for the
Three-Year Period Ended June 30, 1974

| <u>State Agencies</u> | <u>Percentage Of Vehicles</u> <u>1/</u> | <u>Percentage Of Losses</u> <u>2/</u> | <u>Percentage Difference</u> | <u>Total Overcharge (Undercharge)</u> <u>3/</u> |
|------------------------|---|---|----------------------------------|---|
| Conservation | 6.00% | 4.57% | 1.43% | \$ 89,800 |
| Fish and Game | 3.38 | 1.84 | 1.54 | 96,700 |
| Food and Agriculture | 4.46 | 1.71 | 2.75 | 172,800 |
| Highway Patrol | 9.57 | 25.11 | (15.54) | (976,200) |
| Employment Development | 1.46 | 3.60 | (2.14) | (134,400) |
| Motor Vehicles | 1.04 | 1.15 | (.11) | (6,900) |
| Parks and Recreation | 3.66 | .74 | 2.92 | 183,400 |
| State Colleges | 5.58 | 4.02 | 1.56 | 98,000 |
| Transportation | 34.41 | 29.09 | 5.32 | 334,200 |
| Water Resources | 4.09 | .59 | 3.50 | 219,900 |
| All Other Departments | <u>26.35</u> | <u>27.58</u> | (1.23) | (77,300) |
| Total | <u>100.00%</u> | <u>100.00%</u> | | |

1/ The percentage of vehicles was obtained from the inventory of vehicle survey prepared by the Department of General Services as of December 31, 1973.

2/ Percentage of losses was obtained from Farmers Insurance Group's report of losses for the period July 1, 1971 to June 30, 1974.

3/ The overcharge (undercharge) column was computed by multiplying the amount paid for vehicle insurance for the three year period, \$6,281,900, by the percentage difference. For example, the \$89,800 overcharge to the Department of Conservation was calculated thus: $\$6,281,900 \times 1.43 = \$89,831$, round to \$89,800.